Service Date: May 27, 1981

DEPARTMENT OF PUBLIC SERVICE REGULATION
MONTANA PUBLIC SERVICE COMMISSION
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In the Matter of the Application of PACIFIC POWER & LIGHT COMPANY, for authority to establish increased rates for electric service.	UTILITY DIVISION DOCKET NO. 80.8.67 ORDER NO. 4771a

APPEARANCES

FOR THE APPLICANT:
Calvin S. Robinson, Murphy, Robinson, Heckathorn & Phillips, One Main Building, Kalispell, Montana 59901

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FOR THE PROTESTANT:
James C. Paine, Montana Consumer Counsel, 34 West Sixth Avenue, Helena, Montana 59620
John Allen, Consumer Counsel Staff Attorney, 34 It7est Sixth Avenue, Helena, Montana 59620

FOR THE COMMISSION

Calvin K. Simshaw, Staff Attorney
Dan Elliott, Administrator, Utility Division
Eric Eck, CPA

BEFORE:

GORDON E. BOLLINGER, Chairman
HOWARD L. ELLIS, Commissioner
THOMAS J. SCHNEIDER, Commissioner

FINDINGS OF FACT

General

1. Pacific Power and Light (Applicant) is a public utility furnishing electric service to consumers in the State of Montana.

2 . Applicant's petition, filed August 29, 1980, requests this Commission's approval of rates and charges for electric utility service which are designed to produce an increase in annual gross operating revenues of $4,373,0D0, based upon the test period of 12 months ended December 31, 1979.

3. The Montana Consumer Counsel (MCC) has participated in this Docket on behalf of utility customers since the inception of these proceedings.

4. On November 5, 1980, the Commission issued a procedural order.

5. On January 26, 1981, the Commission issued notice of public hearing on the application to adopt increased rates for electric service.

6. On February 25 and 26, 1981, pursuant to the Commission's notice, a hearing to receive

evidence and allow cross-examination was held in the Hideout Room of the Outlaw Inn at Kalispell, Montana.

7. On February 2S, 1981, at 7:00 p.m. pursuant to the Commission's notice, a public hearing was held, at which no public witnesses appeared.

8. At the close of the hearing the Applicant made an oral request for interim relief. On March 2, 1981 Applicant filed a memorandum in support of the motion for interim rate relief.

9. On March 16, 1981 the Commission issued Order No. 4771 which granted interim relief in the amount of $2,828,000. MCC acknowledged the need of .that amount of additional revenue. (Exh. CC-7, Schedule 3, Columns B and C, Line- 1).

10. On April 3, 1981 the Commission received the transcript of the proceedings in this Docket. Initial briefs were due on May 4, 1981. Simultaneous reply briefs were due on May 18, 1981.

11. Applicant proposes the calendar year 1979 be used as the test period in this Docket.

12. The 1979 test year is found by the Commission to be a reasonable period within which to measure Applicant's utility revenues, expenses and returns for the purpose of determining a fair and reasonable level of rates for electric service.

Capital Structure and Associated Costs

13. Applicant proposed the following capital structure and associated costs:

Capital Type	Structure	Cost	Weighted Cost
Long-Term Debt	52.4%	7.76%	4.07%
Preferred Stock	9.7	8.60	.83
Deferred Taxes	3.0	--	--
Common Equity	34.9	14.80	5.17
	100.0%		10.07%

14. MCC proposed the following capital structure and associated costs:

Capital Type	Structure	Cost	Weighted Cost
Long-Term Debt	53.2%	7.76%	4.13%
Preferred Stock	12.8	8.60	1.10
Common Equity	34.0	13.40	4.56
	100.0%		9.79%

15. Applicant proposed to utilize its objective or target ratios in the capital structure, adjusted to reflect the addition of deferred taxes amounting to 3 percent of the capital structure. The Applicant's objective ratios are: 54 percent long-term debt, 10 percent preferred stock and 36 percent common equity (Exh. B, p. 16).

16. M CC does not include deferred taxes in the capital structure. This is consistent with previous Commission decisions to disallow deferred taxes in rate base. Dr. Smith made an adjustment to eliminate nonelectric utility equity from the capital structure.

17. In Docket No. 6728 both the Applicant and MCC recommended that the optimal or target capital structure of the Applicant be used. The present Docket contains a proposal concerning the capital structure as it pertains to subsidiaries. The purpose of developing a capital structure and the associated costs is to determine a fair rate of return for the Applicants utility operations. Components of the capital structure which are related to nonutility subsidiaries must be eliminated. The Commission finds the capital structure proposed by Dr. Smith to be appropriate in this Docket.

Cost of Debt

18. The cost of debt capital is not a contested issue in this case. The cost of long-term debt is based on the embedded debt cost at June 30, 1980, and has been determined to be 7.76 percent by MCC and the Applicant. This cost is acceptable to the Commission (Exh. 2, Table 2-4).

Cost of Preferred

19. The cost of preferred stock is not a controverted issue in this case. The cost of preferred stock is based on the embedded cost of preferred shares outstanding at June 30, 1980, and has been determined to be 8.60 percent by the Applicant and MCC. This cost is acceptable to the Commission (Exh. 2, Table 2-5).

Cost of Common Equity

20. Applicant uses the following methodologies in arriving at a return on equity of 14.8 percent:

a. Application of the Pacific Model (Applicant's Mathematical Model) to the Applicant's financial data. The Model yielded a range of return on equity of 14.15 percent to 15.21 percent.

1. The dividend payout ratio was estimated to be approximately 75 percent, based on the average historical payout ratio for the Applicant over the twelve-year period 1968 through 1979 (Exh. B, p. 8).

2. Net proceeds to market price averaged 96 percent on all electric operating utilities issuing common stock from 1976 through 1979 (Exh. B, p. 9).

3. Annual growth in common equity capital was estimated to be 10 percent. This estimation was derived by reviewing data on growth in net utility plant for the years 1962 through 1979, as Applicant testified that growth in net utility plant is a good indicator of growth in common equity capital (Exh. B, p. 9).

4. The investors discount rate was calculated to be plus or minus 1/2 percent. Mr. Lanz used plus 1/2 percent to account for near-term changes in market conditions (Exh. B, p. 10).

5. Future dividend growth ``as estimated to be 4.5 percent. This estimation was made after reviewing data on compound growth in the - Applicant's dividends per share over 13 different

periods, each ending in 1979 (Exh. B,p. 11).

6. An estimate of the dividend yield was developed by reviewing the Applicant's historical dividend yields, Moody's 24 utility composite historical dividend yields and a historical series of 91 day treasury bill bids. ,The Applicant's dividend yield was estimated to be 9. 51% (Exh. B, p. 14).

b. The Pacific Model's reliability was tested on twenty-five companies which the Applicant feels have investment opportunities similar to that of the Applicant. The selected Companies had September 30, 1973 through September 30,1979 growth in dividends per share plus September 30, 1979
dividend yield between 13.7 percent and 14.7 percent. The average return granted to these twenty-five Companies was determined to be 13.54 percent, which is within the range of returns produced by the Pacific Model, 13.47%-14.55% (Exh. B, p. 16).

21. MCC uses the following methodologies in arriving at a return on equity of 13.4 percent:

a. Application of discounted cash flow (DCF) techniques to Applicant's financial data. The DCF methodology yielded a range of return on equity of 13% to 13.6%.

1. Dividend yields for 93 electric and gas utilities traded on the New York Stock Exchange were calculated on a pre-Three Mile Island basis and an updated September,
1980 basis. The dividend yields were calculated on the basis of an average price. The pre-TMI

yield was found to be 9. 5%, the 1980 dividend yield was 11. 5% (Exh. CC-8, Appendix B, p. 2).

2. Expected dividend growth was calculated by examining growth rates in dividends, earnings and book value over a ten year period for the Companies in the study. The weighted average growth for these companies was 3.3% in the pre-TMI period and 3% for the more recent period (Exh. CC-8, Appendix B, p. 4).

3. The model used by MCC was used to identify differences between the cost of equity for the Applicant and the industry as a whole.

b. The reasonableness of the D CF approach was examined by performing two comparable earnings studies. A tabulation of earned rates of return for 94 electric and combination utility companies indicated that average earnings on equity for the 1970-1979 period were in the 11 percent to 13 percent range (Exh. CC-9, CMS-4). In the second study companies which had beta coefficients similar to utilities for 1979 had returns on book value from 13 .99 percent to 14.26 percent (Exh. CC-9, CMS-S, p. 2).

22. Both MCC and the Applicant used a D CF model to determine the cost of equity in this proceeding. In each model there are elements which are based upon the judgment of the particular witness. In viewing the two models presented, the major difference appears to be the use of a large number of companies in the MCC proposal while the Applicant relies on the Pacific Model to estimate the cost of equity for Pacific Power and Light. Of the two methods

the Commission prefers the MCC approach as it, through the process of evaluating many companies, eliminates factors which are unique to a particular form.

Although the Commission agrees with MCC as to which D CE model to use, there are several issues which must be resolved. In Docket No. 6728 a witness for MCC recommended an overall rate of return of 9.83 percent. In this case Dr. Smith recommends an overall return of 9.79 percent. The Commission after reviewing the record finds no evidence to indicate that the cost of capital has declined since Order No. 4667. As a result the Commission makes an explicit adjustment to the recommended equity return of MCC.
The Commission accepts the upper range recommended by Dr. Smith of 13.6 percent.

In her testimony Dr. Smith indicates that there is no need for an allowance for market pressure. One of the main arguments advanced by Dr. Smith was that market pressure can be either positive or negative (Exh. CC-8, p. 38). To demonstrate this concept, Exhibit CC-9, CMS-8 was presented. This exhibit was intended to demonstrate the existence of positive market pressure. In his rebuttal testimony Mr. Lanz indicated that there were errors in Dr. Smith's exhibit and in fact positive market pressure had not been a factor (Exh. C, Table 2). Based upon specific evidence presented in this Docket, the Commission agrees that market pressure does exist and makes an allowance of 15 basis points.

Rate of Return

23. Based on the findings for long-term debt, preferred stock and common equity, the following capital structure and costs are determined appropriate:

Capital Type	Weighted Structure	Cost	Cost
Long-Term Debt	53.2%	7.76%	4.13%
Preferred Stock	12.8	8.60	1.10
Common Equity	34.0	13.75	4.68
	100.0%		9.91%

Rate Base

24. The following rate base proposals Were submitted. The final column is the rate base approved by the Commission.

1979 Test Year
(000)

Average Rate Base	Applicant Rate Base	Adj. by Consumer Counsel	Consumer Counsel Rate Base	Approved Rate Base
Net Plant in Service	$56,489	$1,063	$57,552	$57,552
Plant Held for Future Use	138	(77)	61	61
Acquisition Adjustment	2	(2)	--	--
Nuclear Fuel	24	--	24	24
Customer Advances for Construction	(291)	--	(291)	(291)
Materials and Supplies	1,039	--	1,039	1,039
Working Capital	207	--	207	207
Unamortized Leasehold Improv. etc.	486	--	486	486
ustomer Contributed	--	(1,771)	(1,771)	(1,771)

Unamortized Investment				
Tax Credits	--	(192)	(192)	(192)
TOTAL	$58,094	$ (979)	$57,115	$57,115

Net Plant in Service

25. An error in the preparation of the Applicant's case resulted in a reduction of the rate base. MCC witness Mr. Hess replaces $1,063,000 in the rate base to correct the error. This adjustment is accepted by the Commission.

Plant Held for Future Use

26. Applicant's rate base included $138, 000 of plant held for future use. MCC proposed an adjustment to remove $77,000 of this amount as the property is not expected to be placed in service before 1990. Current ratepayers should not be burdened with carrying costs of property which will not be used for service for 11 or more years. The Commission agrees that the MCC adjustment is correct and finds the amount of $61,000 to be the proper amount of plant held for future use included in rate base.

Acquisition Adjustment

27. Applicant's proposed rate base included an acquisition adjustment in the amount of $2,000. The rate base proposed by MCC eliminates this amount. Removal of this acquisition adjustment is consistent with past Commission action. The Commission finds that the $2, 000 acquisition adjustment should be eliminated.

Customer Contributed Capital

28. The Applicant proposed including deferred taxes at zero cost in the cost of capital and including these customer contributed funds in rate base. MCC proposes to eliminate the deferrals from rate base. The Commission consistent with prior decisions finds the removal of deferred taxes from rate base to be correct. The amount of the deduction is $1,771,000.

Unamortized Investment Tax Credits

29. Consistent with Finding of Fact 28 the Commission finds that unamortized investment tax credits are properly deducted from rate base. Based upon an adjustment in the revenues and expenses section, the amount of tax credits to be deducted is increased. In order to achieve an average adjustment one-half of the net expense adjustment is deducted from rate base.

Revenue and Expenses

30. The Commission finds that additional annual revenues in the amount of $2, 974, 000 are needed by the Applicant. This amount is arrived at by adding line 1 columns (B) & (C) in the following table. The final column contains the revenue and expense amounts approved by the Commission:

DERIVATION OF ADDITIONAL REVENUES REQUIRED TO PRODUCE 9.91% RATE OF RETURN
MONTANA ELECTRIC OPERATIONS

1979 TEST YEAR
(000)
Adjustment for Rate Increase

	Pro Forma Present Rates (A)	To Eliminate Negative Tax (B)	To Produce 9.91% Rate of Return (C)	Approved Revenues and Expenses (D)
1. Operating Revenues	$16,576	$412	$2,562	$19,550
2. Operating Expenses				
3. Depreciation and	9,744	1	8	9,753
Amortization	1,997	--	--	1,997
4. Taxes Other than Income	1,322	--	2	1,324
5. State Income Tax (1)	(26)	28	172	174
6. Federal Income Tax				
7. Before Inv. Tax Cr. (1)	(175)	176	1,095	1,095
8. Inv. Tax Cr.			(766)	(766)
9. Net Federal Income Tax	$ (175)	$176	$ 329	$ 329
10. Deferred Income Tax	45	--	--	45
11. Income Tax Deferred in Prior Years	(89)	--	--	(89)
12. Investment Tax Credit Adjustment				
13. Deferred	--	766	766	766
14. Restored-Current Year	--	--	(383)	(383)
15. Restored-Prior Years	(28)			(28)

16. Net Adjustment	$ (28)		$ 383	$ 355
17. Operating Revenue Deductions	$12,790	$205	$ 894	$13,889(2)
18. Net Operating Revenues	$ 3,786	$207	$1,668	$ 5,661
19. Rate Base	$57,307		$ (192)	$57,115
20. Rate of Return				9.91%

(1)	State	Federal
Negative Tax Per Company	$(25)	$(167)
Tax on MCC Expense Adjustments	18	124
Tax on LICC Interest Adjustment	(19)	(132)
Adjusted Total	(26)	$(175)

(2) This column is adjusted for rounding.

Advertising and Research Expense

31. MCC witness Mr. Hess eliminated $11,000 of institutional advertising and $6,000 of an increase in EEI research billings. With respect to the advertising expense, this type of expense does not benefit the ratepayer and is not allowed in this Docket.

EEI bases its charges on revenues and kilowatt-hour sales. Mr. Hess stated in his testimony "Test year expense should not be adjusted for increases associated with growth in sales." The Commission agrees with that conclusion as these costs will be offset by increased revenues. The reduction in research expenses proposed by MCC is accepted.

Captive Coal

32. MCC proposed an adjustment to eliminate the profit from Jim Bridger Coal which exceeded the rate of return granted to utility stockholders. Mr. Hess calculated a return on mining investment of 47 percent excluding CWIP. It is also noted that the coal mining facilities at Centralia and Dave Johnston are included by the Applicant in rate base. Therefore, limiting the return on Bridger coal purchases to the 13.75 percent return on common equity accepted by the Commission, is consistent with Applicant's treatment of coal costs at Centralia and Dave Johnston.

The Applicant holds that the normalized price per ton of $10.13 utilized by the company shall be accepted as it is less than the fair market price of the coal. Mr. Watson presented a table which supported the following conclusion:
Bridger's contract price for coal sold to Pacific in 1980, and the normalized price per ton of $10.13 utilized by the Company in its direct case, were more favorable to electric ratepayers than 28 of 32 supply arrangements for which data was available for 1980.

Also, since the Bridger plant is a mine mouth plant, transportation costs are excluded.
The Commission finds that the rate of return methodology is proper for considering Applicant's coal subsidiary. The process of using market price is not used by the Commission because the reliability of such a measurement is uncertain. The decision of whether or not transportation costs should be included in a market price is a good example of how difficult a market price is to determine. The Commission is persuaded that the rate of return methodology is the appropriate way to evaluate sales from Bridger Coal. Since the Commission found a higher return on equity, the amount of profits in excess of 13.75 percent on equity is $252,000. This amount is deducted from operating expenses.

Pro Forma Interest

33. Mr. Hess makes a pro forma interest adjustment to reflect

interest expense associated with construction work in progress. Mr. Hess states in his testimony:

Interest associated with construction funds is deducted for income tax purposes. Failure to reflect the deductibility of such interest would result in allowing for rate making purposes income taxes in excess of the amounts that will be paid. (Exh. CC-7, p. 10)

The Commission agrees with the proposed MCC pro forma interest adjustment. The amount of the adjustments is ($19,000) State Tax and ($132,000) Federal Tax.

Investment Tax Credits

34. MCC contends that the eight year modified flow through of investment tax credits is unfair to current ratepayers. As an alternative, Mr. Hess has proposed to restore one-half of the investment tax credits that can be utilized in the test year.

The Applicant rejects the proposal of Mr. Hess as being discriminatory and unreasonable. Mr. Watson states that an eight year restoration is preferable for both the company and the ratepayers. Applicant notes correctly that a variety of methods are used by utilities in accounting for investment tax credits.

The Commission concludes after reviewing the points raised by all parties concerning investment tax credits that the method proposed by MCC should be adopted.

Mr. Hess points out that with a large construction budget and unchanged tax laws, tax reductions due to investment tax credits will continue to occur year after year. That being true, there is no reason to defer recognition of the benefits for eight years as was done in the previous Docket. Current ratepayers are entitled to receive a larger share of the benefits they produce through current rates. The amount of the approved investment tax credit adjustment is calculated to be $766,000.

Rate Design

35. In its application for authority to adopt new rates and charges for electric service, PP&L proposes to adopt the existing rate structure and increase each rate schedule on a uniform cents per kwh basis. The absence of a rate design proposal was due to the active status of Phase II of Docket No. 6728 which provides an examination of PP&L's rate design.

36. Order No. 4667b in Docket No. 6728, issued concurrently with this Order, provides the existing rate structure from which PP&L shall design rates to recover the authorized level of revenue.

37. In compliance with Order No. 4667b, the Commission finds that the authorized level of revenue shall be recovered by equip-proportionately increasing the energy charge in the tail block of the residential schedule and the energy and demand charges of all other schedules, thus maintaining time-of-use differentials.

38. This action by the Commission precludes the examination of rate design in this Docket.

CONCLUSIONS OF LAW

1. The Applicant, Pacific Power and Light Company, is a "public utility" within the meaning of Montana Law, Section 69-3-101, MCA.

2. The Commission properly exercises jurisdiction over the Applicant's rates and operations pursuant to Sections 69-3-102 and 69-3-302, MCA.

3. The rate structure approved herein is just, reasonable and not unjustly discriminatory.

ORDER

1. The Pacific Power and Light Company shall file rate schedules effective for service rendered on and after May 26, 1981 which reflect increased annual revenues of $2,974,000.

2. Rate schedules filed shall comport with all Commission determinations set forth in this order.

3. All motions and objections not ruled upon are denied.
DONE AND DATED this 26th day of May, 1981, by a vote of 3-0.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION.

Gordon E. Bollinger Chairman

Howard L. Ellis, Commissioner

Thomas J. Schneider, Commissioner

ATTEST:

Madeline L. Cottrill Secretary

(SEAL)

NOTE: You may be entitled to judicial review of the final decision in this matter. If no Motion for Reconsideration is filed, judicial review may be obtained by filing a petition for review within thirty (30)days from the service of this order. If a Motion for Reconsideration is filed, a Commission order is final for purpose of appeal upon the entry of a ruling on that motion, or upon the passage of ten (10) days following the filing of that motion. cf. the Montana Administrative Procedure Act, esp. Sec. 2-4-702, MCA; and Commission Rules of Practice and Procedure, esp . 38.2.4806, ARM.